Supreme Court, U.S.
FILED
AUG - 8 2000
CLERK

(3)

No. 99-1834

In the

Supreme Court of the United States

KENCO RESTAURANTS, INC. ; K-K RESTAURANTS, INC. ;
TIFFIN AVENUE REALTY COMPANY, INC. ;
BRYAN REALTY, INC. ,

Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF

JOHN D. STEFFAN
4020 University Dr.
Suite 207
Fairfax, VA 22030
(703) 691-4810

MARINA TRAMONTOZZI
Counsel of Record
Suite 601-S
815 15th Street, N.W.
Washington, D.C. 20005
(202) 393-1070

Attorneys for Petitioners

14 pp

TABLE OF CONTENTS

ARGUMENT 1

CONCLUSION 10

APPENDIX

TRANSCRIPT EXCERPTS sa1

TABLE OF AUTHORITIES

CASES

COHAN V. COMMISSIONER,
39 F.2D 540, 544 (2D CIR. 1930).....6

ELI LILLY & COMPANY,
856 F.2D 855, 860 (7TH CIR. 1988).....8

WAL-MART STORES, INC. & SUBSIDIARIES V. COMMISSIONER,
153 F.2D 650, 656-58 (8TH CIR. 1998).....6

ARGUMENT

The essence of the Brief for the Respondent in Opposition ("Respondent's Brief") is that the Taxpayers failed to prove that the Commissioner's reallocation was arbitrary, capricious or unreasonable. The premise is two-fold: (1) The Tax Court held that the Taxpayers' proffered expert was not qualified to opine on reasonable management fees (resulting in the implication that the Taxpayers failed to prove the arbitrariness of the Notices of Deficiency); and (2) the Respondent's expert ("Moore") opined that the fee allocations made by the Taxpayers were inconsistent with an arm's length transaction.

The loss of the Taxpayers' expert is irrelevant where the record otherwise provides sufficient evidence from any source to sustain the Taxpayers' burden of proof. *National Semiconductor Corp. v. Commissioner*, 67 T.C.M. (CCH) 2849, 42 (1994). Such evidence was provided by Moore whose result and opinion differed so significantly from that of Respondent's Revenue Agent ("Camper") and the Notices of Deficiency that the Commissioner was compelled to concede at trial that the Commissioner would abandon any differences in the results of the Notices based on Moore's reallocation (which, the Taxpayers submit, clearly exhibits that the Commissioner abandoned Camper's methodology and result at trial[1]). Whether

---

[1]Nothing can be clearer on the abandonment than the following colloquy:

> THE COURT: Well, she [Moore] has amounts that she thinks are the proper allocation and your revenue agent did the same thing, but they're different.
>
> MS. HELFGOTT: Right. So our position is the position of our expert. To the extent that her position requires a concession on our part, that's our position.

(TR 327-28, L14-8, APP 47a).

or not the Respondent abandoned the Notices of Deficiency would become moot if it were shown, as here, that the Respondent introduced the affirmative evidence establishing the Notices of Deficiency as arbitrary, capricious or unreasonable -- the testimony and report of Moore. The Respondent's position is that Moore's analysis was introduced "only to prove a reasonable allocation on the contingency that petitioners succeed" in bearing the first burden of proof. Respondent's Brief at 5-6. This is an illogical posture. Simply, Moore used a different methodology and obtained a different result. The touchstone of Section 482 is that of an "uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Such a standard, despite the methodology employed, should provide a result within a reasonable range of prices. If the prices obtained are seriously divergent, those outside the reasonable range are per se unreasonable. Any other view would permit the Commissioner to shop methodologies to select one that would produce an advantageous result, virtually unchallengeable by any taxpayer. *National Semiconductor Corp.*, 67 T.C.M. (CCH) at 39 (Respondent cannot contend that the notice adjustments are "reasonable" on the one hand while adopting an analysis that rejects such adjustments as unreasonable on the other.). The Respondent's own expert establishes that Camper's methodology and result were fatally flawed, that is, arbitrary, capricious or unreasonable.

The distinction between Moore's and the Taxpayers' methodologies is that Moore merely added more hours of a select few BKK employees[2] to the equation so as to dilute the hourly management fees charged in half. The unchallenged numerator was the total costs of BKK. The disputed denominator was either 6,000 owner/manager hours allocated by the Taxpayers or the erroneous 12,050 hours allocated by Moore[3].

Not one scintilla of rebutting evidence was introduced to vary the Taxpayers' hours as allocated. Ms. Moore testified that she could not establish any variance in the hours as allocated. Indeed, Ms. Moore essentially used the same allocation of hours of owner/manager hours among the corporations as did the Taxpayers (except for her erroneous, unsubstantiated reallocation of one owner's time which is not critical to this analysis).

Ms. Moore very clearly vouched for the reasonableness of the Taxpayers' method:

> THE COURT: So do I take it that one of your conclusions is that an allocation based on time is proper if time is accurately allocated to the costs?
>
> THE WITNESS [Ms. Moore]: If the time is accurately allocated and if the underlying

---

[2]Contrary to the Respondent's contention that Moore included the hours of all employees. Respondent's Brief at 4. Indeed, Moore only included the hours of three additional select persons, a district manager, a maintenance man, and the BKK accountant (who was not even an employee of BKK for eleven months of the last year in issue).

[3]Indeed, the Tax Court noted that it was apparent that Moore started with her desired results and derived the number of hours necessary to obtain result. She did not start with the number of hours and answer the question as to whether those hours were spent as the Taxpayers said they were. (TR 334-335, L 3-19, APP 48a-50a).

services provided for are provided for at a reasonable dollar value. So I guess, yes, we're saying that I don't have a problem with allocating it based on time.

THE COURT: But here you didn't change the underlying dollar value because indeed that was fixed by your commission, wasn't it?

* * *.

THE WITNESS: Correct. No, we didn't.

THE COURT: Nor per hour dollar allocation, because you didn't change the total number of hours, either. You allocated the time –

THE WITNESS: Right.

THE COURT: -- based on percentages allocable -- of total time or each individual time actually allocable to each restaurant, right?

THE WITNESS: Right.

THE COURT: You accepted the number of hours.

* * *.

THE WITNESS: Yes. Yes.

THE COURT: And you thought that was a reasonable number of hours overall, I take it.

THE WITNESS: Yes.

THE COURT: And since you were only allocating, I think, $900,000 worth of cost a year.

* * *.

THE COURT: * * *. But you thought that was reasonable, too, I take it.

THE WITNESS: Well, let me --

THE COURT: It was fixed, at least.

THE WITNESS: It was fixed. We didn't question the total dollar amount that was allocated. That was outside the scope of what we were told to do.

THE COURT: So not having questioned the total amount that was allocated and not having questioned the number of hours involved, you certainly then weren't questioning the dollar value per hour, because that was simply a product of division, wasn't it?

When you divide the number of hours into the dollars, you come out with a per hour allocation.

THE WITNESS: Yes. Per hour based on total hours, yes.

THE COURT: On the figures you were given.

THE WITNESS: Right. That's correct.

THE COURT: So I guess the conclusion -- just to reemphasize this one more time and we'll come back to this in other parts of your report -- was the methodology of allocating overhead costs on the basis of hours allocable to each of the targets is a reasonable method of allocation.

Is that your conclusion?

THE WITNESS: Yes.

THE COURT: Yes. Fine. And indeed that's one of the conclusions expressed in this badly written sentence.

THE WITNESS: Very badly written.

THE COURT: But that is one of the conclusions that's inherent in there.

(TR 295-297, L 9-22, APP 41a-43a; see also TR 313, L 12-23, SA1).

Having explicitly agreed to the reasonableness of the Taxpayers' time-based allocation methodology, hours and amount, Moore's oral testimony compels the conclusion that the Taxpayers' results were reasonable, i.e., reflected an arm's length price. As the Tax Court correctly noted, having not questioned the total dollar amount allocated and having not questioned the number of hours involved, Moore could not and, in her oral testimony, did not question the dollar value per hour. Therefore, in order to reach a result different than that obtained by the Taxpayers, the only thing that Moore could possibly do was to increase the number of hours in the equation, thereby halving Taxpayers' hourly transfer price. In reality, a substantial portion of Moore's oral testimony was quite different from her expert report. In her report, Moore did change the number of hours involved. This change was very significant in that it more than doubled the number of hours to be allocated and, as a result, essentially halved the hourly transfer price.

The Respondent also erroneously asserts that "[t]he owners did not maintain records of the number of hours actually spent on each corporation during any given year." Respondent's Brief at 2. This is incorrect. The Taxpayers maintained computer generated spreadsheets for each year. At the commencement of the year, they were adjusted to reflect anticipated time at each corporation. But more than that, they were adjusted during each year to reflect time **actually spent** on each corporation. Moreover, estimates are commonly accepted and endorsed in the law. *See, e.g., Wal-Mart Stores, Inc. & Subsidiaries v. Commissioner*, 153 F.2d 650, 656-58 (8th Cir. 1998); *Cohan v. Commissioner*, 39 F.2d 540, 544 (2d Cir. 1930).

To deduce a proper transfer price, Moore relied upon Robert Morris Associates' ("RMA") compiled data in a variety

of fields.[4] The RMA data, Trial Exhibit C-K at Exhibit 26, (see Lodging[5] at L48) details the ratio of officer compensation costs to net sales. These officer compensation costs are strictly for the "upper management level." Moore used a 9.9% industry guideline to reach the conclusion that, for example, the 15.9% and 14.6% used by the Taxpayers are excessive K-K and Kenco costs respectively. Therefore, she adjusted the management cost share percentages. If BKK's incidental costs and the other costs unrelated to officer compensation were properly omitted from line 2 of Exhibit C-K at Exhibits 26, 27 and 28, (Lodging at L48 - L50) i.e., if only owner compensation was used, the costs would decrease significantly, resulting in percentages very much in line with the RMA guidelines. That is, properly applied, the RMA supports the Taxpayers, not the Respondent.

For example, the 1990 BKK officer compensation was only 68.2% of the 1990 management cost shares. This is determined by examining the relationship between the BKK officer compensation ($542,141), at line 12 of the 1990 BKK Corporate Tax Return (Trial Exh. 12-L), and BKK's total expenses ($794,876), at line 27 of Exhibit 12-L. Therefore, Moore has significantly overstated line 2 of Exhibit C-K at

---

[4]The preamble to the compilation of data establishes that the "data may be regarded only as general guidelines and not as absolute industry norms . . .." As a result the data provides for a wider range of acceptable norms/parameters than was suggested by Moore who treated this data as precise industry norms.

[5]A trial exhibit has been lodged with this Court. The citations "L__"are to the Lodging and its pagination.

Exhibit 26 (Lodging at L48). Instead of the 15.9% and 14.6% that Moore determined for K-K and Kenco respectively, the proper relationship of officer compensation to net sales is 10.81% and 9.95% for K-K and Kenco, respectively. This is well within the ambit of the RMA Guideline of 9.9%.

Not only does the Taxpayers' allocation not deviate significantly from a transfer price that the RMA suggests when properly applied, Moore's allocation deviated from the Notices of deficiency to such a degree that it compelled the Respondent to concede the position of the Revenue Agent at trial. When properly applied, Moore not only impeaches the reasonableness of the Revenue Agent's transfer price but, in fact, supports the Taxpayers. The Taxpayers are entitled to rely upon Moore's evidence to prove the Notices of Deficiency as being arbitrary, capricious or unreasonable. That the Taxpayers' transfer price is within acceptable parameters of a reasonable transfer price when measured against the RMA Industry Guidelines was conceded by Moore at trial under examination by the Court in allowing that the owner/manager time was reasonable and the owner/manager costs were reasonable. When combined with unimpeached testimony regarding the actual allocation of owner/manager time to the respective corporations, the evidence shows that the actual transfer price is within an acceptable range of an arm's-length price and that the Notices of Deficiency are arbitrary, capricious and unreasonable.

When faced with divergent interpretations of a correct transfer price, the Seventh Circuit in *Eli Lilly & Company*, 856 F.2d 855, 860 (7th Cir. 1988), provides the proper resolution: remand to the trial Court for a finding of a correct transfer price rather than adopt one or the other.

But, more than that, for the reasons self-evident on this record, *Eli Lilly* suggests that the Respondent, indeed, bears some affirmative obligation to support its allocations at trial. Respondent did not do that. It can be argued that the Tax Court agreed with Seventh Circuit when it noted that the

Commissioner had not "put in one wick of evidence" through her Revenue Agent. The Tax Court closed cross-examination into the Camper methodology and result. Moreover, the Respondent argues that Moore's allocations are contingent in nature, **i.e.,** not in affirmative support of the Camper allocations. Without some minimal burden, the Respondent is free to select any criteria or method it wishes to compel the Taxpayers to suit with an onerous burden of proof. This Court need only review the Notices of Deficiency to see that they contain absolutely no substantive indication of how the deficiencies were derived.

Under the Sixth Circuit's analysis, but not result, the Taxpayers succeeded in showing that their transfer price was reasonable (unchallenged hours divided into unchallenged costs), ergo the Notices of Deficiency are arbitrary, capricious or unreasonable. To prove the first burden, the Taxpayer need only satisfy the second burden. However, if the taxpayer fails the second burden, it automatically fails the first burden. The Sixth Circuit held that the Taxpayers failed to meet the second burden and therefore failed the first burden. Even though the Sixth Circuit's burden is facially advantageous to the Taxpayers, it deprives the Taxpayers of the opportunity to have a correct allocation deduced by the Tax Court in the event, as here, that taxpayers are deemed to have failed in proving its allocation as being arm's-length. That is, the failure of the Taxpayer to prove the reasonableness of its transfer price, satisfying both burdens of proof as stated by the Sixth Circuit, results in the failure to prove the Respondent's transfer price as arbitrary, capricious or unreasonable and therefore compels the Court to accept an "all or nothing" approach, when neither price may accurately reflect a true arm's-length price. Not only is this an erroneous application of the correct burden of proof, it leaves the Tax Court to take a simple all or nothing position, clearly frowned upon by the Seventh Circuit with potentially inequitable results.

CONCLUSION

The correct result is to grant the Petition for Writ of Certiorari.

Marina Tramontozzi
Counsel of Record
815 15th Street, N.W.
Suite 601
Washington, D.C. 20005
(202) 393-1070

John D. Steffan
Steffan & Associates, P.C.
Suite 207
4020 University Drive
Fairfax, Virginia 22030

a per hour basis -- and I would tell you that each hour carried with it a charge of $148 or whatever number you get by dividing the two givens you were given, the total dollars and --

THE WITNESS: Right.

THE COURT: If I were to tell you that each hour carried the charge of $148 and that the hours allocated by the Petitioner actually were the hours, you'd then come up with a cost charge for overhead for each of the targets. Right?

THE WITNESS: Yes.

THE COURT: Given what you've said to me already, do you -- can you tell me, as a matter of your professional ability and competence, that those charges are unreasonable?

THE WITNESS: If the dollar -- if you're going to give me as a given in that scenario that each hour is worth $148 --

THE COURT: Or whatever it is.

THE WITNESS: Or whatever it is.

THE COURT: Dividing those two numbers.

THE WITNESS: Then I would have to say I have -- then no, I wouldn't have a basis for saying that the charge is unreasonable.

THE COURT: Okay.

THE WITNESS: THE ISSUE THEN BECOMES WHETHER EACH